No. 70-305

IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

FIRST SECURITY BANK OF UTAH, N.A., et al.

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

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BRIEF FOR THE RESPONDENTS

S. J. QUINNEY
ALONZO W. WATSON, JR.
STEPHEN H. ANDERSON
RAY, QUINNEY & NEBEKER
400 Deseret Building
Salt Lake City, Utah 84111
Counsel for Respondents

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QUESTION PRESENTED

May the Commissioner, pursuant to Section 482 of the Internal Revenue Code, allocate to the taxpayer national banks insurance-related income which the Banks did not and could not receive due to prohibitions of the federal banking laws, thus resulting in a tax where there is no income?

STATEMENT

Respondents are Utah and Idaho national banks subject to the control of the Federal Reserve system, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency. They are subsidiaries of First Security Corporation (Holding Company), a publicly owned bank holding company—the oldest in existence. In addition to the Banks,

the Holding Company had other (non-banking) subsidiaries, including First Security Life Insurance Company of Texas ("Security Life"—a life insurance company), Ed. D. Smith and Sons ("Smith"—a corporate insurance agency) and First Security Company ("Management Company"—a management company which provided management and accounting services to the group).[1] (R.164-166.)

Since 1948, the Banks have made available to their loan customers credit insurance, which will pay off the debt if the customer dies or becomes disabled. This was done to offer customers a service which competing lenders were increasingly supplying, to obtain additional collateral for the debt (in the form of insurance), and to obtain an additional source of income from part of the insurance premiums. (R.166.) The premium, $1.00 per year per $100.00 of insurance coverage, was the rate commonly charged in the industry and was approved by the insurance commissioners of Utah and Idaho. (R.166, 170.)

Contrary to implications in the Commissioner's brief (Br. 6, 8, 13, 17), the banks did not push the sale of insurance. They did not require their loan customers to take credit insurance and less than 50% of their installment loan customers and 13% of their mortgage loan customers subscribed. It was simply a minor part of the routine of the Bank's loan officers (who were not licensed insurance agents) to explain the function of credit insurance and, if

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1. In September, 1959, pursuant to a reorganization to comply with the Bank Holding Company Act of 1956 (12 U.S.C. § 1841 et seq.), the Banks and the Management Company were placed in a newly organized bank holding company, whose stock was distributed to the stockholders of the old holding company, which retained the non-banking subsidiaries, including Security Life and the insurance agency. Thereafter, as a result of public trading, the stock ownership of the two holding companies became substantially different. (R. 165, 185.)

the customer wanted it, to take the application (consisting of just four lines), collect the premium, and give the customer his insurance certificate. The cost to the Banks for the actual time involved in explaining and processing the insurance was less than $2,000 per year, characterized by the courts below as "negligible."[2] The paperwork and bookkeeping involved in the Banks' credit insurance program were handled by the Management Company, which received the applications, duplicate certificates, and premiums from the Banks, kept records of the insurance written, forwarded premiums to the insurance company, and processed claims. The cost to the Management Company of processing credit insurance for both Banks was about $2,000 per year, also characterized by the courts below as "negligible". (R.169-170, 184.)

Prior to April, 1954, the Banks' credit insurance underwriters were unrelated insurance companies which paid commissions ranging from 40-55% of premiums to the Holding Company's insurance agency subsidiary, Ed. D. Smith and Sons, under agency agreements appointing Smith as their agent to write credit insurance. (R.166-167.)

Late in 1953, American National Insurance Company of Galveston, Texas approached the Holding Company with a plan under which it would act as the prime underwriter for the Banks' credit insurance, providing record keeping, insurance accounting, and actuarial services for a fee, and then reinsure all of the risks with an insurance subsidiary to be formed by the Holding Company, with the expectation

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2. Contrary to the Commissioner's assertions (Br. 6, 12-13, 28), in performing the incidental activities required to make credit insurance available to borrowers, the Banks' loan officers were agents of the customers and acting for the Banks' benefit; they were not agents of the insurance company. (R. 69.) *Boseman* v. *Connecticut General Life Insurance Co.*, 301 U.S. 196, 204-205.

that the reinsurance subsidiary would ultimately grow into a full-line, direct-writing insurance company. American National evolved this plan anticipating that sophisticated lending institutions would recognize that credit insurance was profitable and, sooner or later, would form their own insurance companies to underwrite the business.[3] At least, under the proposed plan, American National would recoup something, through the service fee, for its experience and facilities for handling credit insurance. (R.167-168.)

The Holding Company adopted American National's plan and, with the approval of the Texas Board of Insurance Commissioners, formed a new subsidiary, First Security Life Insurance Company of Texas, with an initial capital and paid-in surplus of $37,500 (later increased to $100,000).[4] In April, 1954, the Banks began placing their credit insurance with American National, which in turn reinsured all of the risks with—and remitted all of the premiums to—Security Life, under reinsurance treaties which allowed American National to keep 15% of net premiums for keeping First Security's books and records and computing its actuarial reserves. (R.168-169, 185.)

Although Security Life's credit insurance business was successful, there was no way to predict this at the outset; for, as the following table shows, Security Life insured a

3. There were a variety of business reasons for forming Security Life. Moreover, there was also a possible tax advantage in taking the credit insurance profit in the form of insurance premium income (assuming a favorable loss experience), since only the investment income of a life insurance company was taxed. This potential advantage was largely eliminated in the Life Insurance Company Tax Act of 1959. (R. 133, 141, 168.)

4. Security Life was not rare or unusual. It is common practice in the insurance industry to begin an insurance company by reinsuring risks, to avoid large initial capital requirements. (R. 83, 169.)

large amount of risk in relationship to its capital structure (R.170-171):

Analysis of Risk Assumed By Security Life Insurance Company

Year	Number of policies reinsured	Amount of risk at year-end	Extra claims which would have eliminated surplus*
1954	12,500	$ 6,483,000	3
1955	27,594	13,360,000	9
1956	34,388	21,105,000	28
1957	29,591	25,570,000	28
1958	32,155	36,761,000	50
1959	36,416	41,350,000	97

* Assuming claims of $5,000 per policy, the maximum coverage under Security Life's policies.

Security Life was a relatively small company that was facing the possibility of high mortality claims because the Banks' customers could obtain credit insurance without medical examination or a waiting period and customers were concentrated in a limited geographical area which could be affected by a common disaster or disease. (R.172.)

The officers of the Holding Company and the Banks believed, on advice of counsel, that it would be a criminal violation of federal banking law for the Banks to receive any income from their customers' purchase of credit insurance. Consequently, the Banks never received—or attempted to receive—commissions or any other compensation from the credit insurance program. (R.172.) The Commissioner now accepts (Br. 29) the fact that the Banks' understanding of federal banking law prompted them to "structure their affairs so as to remain aloof from the receipt of insurance-related income."

In his statutory notices of deficiency, the Commissioner determined that all of the insurance premiums received by Security Life from 1955 through 1959 should have been reported by the Banks or, alternatively, by the Management Company, without citing any statutory authority. Two days before trial in the Tax Court, the Commissioner gave notice that he would rely on § 61 and § 482 of the Internal Revenue Code of 1954. During trial, the Commissioner abandoned his attempt to reallocate premium income attributable to mortgage, borrow-by-check and twin-dollar forms of credit insurance, leaving for the proposed reallocation only Security Life's installment loan credit life and disability insurance premiums. The Commissioner also urged, during trial, that only 40%—rather than all—of those premiums be taxed, alternatively, to the Banks or the Management Company. (R.172-173.)

Feeling that the result was dictated by the Tax Court's decision in *Local Finance Corporation* v. *Commissioner*, 48 T.C. 773, affirmed, 407 F.2d 629 (7th Cir.), certiorari denied, 396 U.S. 956, from which he had dissented, Judge Fay of the Tax Court approved the Commissioner's allocation of 40% of Security Life's net credit insurance premiums on installment loans for 1955 through 1959 (about $800,000) as income to the Banks and entered decisions determining income tax deficiencies, attributable to the additional income, aggregating about $400,000. (R.173-179.)

Rejecting the Commissioner's theory that the Banks should be taxed on First Security's premium income because they generated the insurance business and finding that the Commissioner's allocation under § 482 of the Internal Revenue Code was arbitrary, capricious, and inconsonant with basic concepts of federal income taxation because the Banks neither earned nor received nor could have *lawfully* received any income from the credit insurance program, the Tenth Circuit reversed the Tax Court's deter-

mination of deficiencies against the Banks and remanded the case involving the Commissioner's alternative allocation to the Management Company to the Tax Court for further factual consideration. The Tenth Circuit expressly noted—and disagreed with—the Seventh Circuit's decision in the *Local Finance* case. (R.182-192.)

SUMMARY OF ARGUMENT

I.

The underlying premise of Section 482—which permits the Commissioner to reallocate income between controlled entities—is the unfettered power of the controlling parties arbitrarily to understate the income of one entity in favor of another. Here, no power existed to understate the Banks' income by excluding insurance commissions, since federal banking law made it impossible for the Banks to receive insurance-related income under any circumstances.

Thus, the Commissioner has misconstrued and misapplied his own § 482 regulations by reclassifying reinsurance premium income as commission income and attributing it to National Banks which did not—and could not lawfully—receive it, regardless of the common control of the Banks and the Insurance Company by the Holding Company. In order to achieve that result, the Commissioner urges disregard of all applicable precedents and a novel interpretation of § 482 which would expand—and distort—the accepted definition of gross income in the tax laws.

II.

Through the years there have been many cases involving an attempt by the Commissioner, on one theory or another, to restructure transactions involving insurance-related income derived incidentally to banking, finance company, and automobile sales transactions. Such cases frequently involved state laws which inhibited any form of compensa-

tion, by commission or otherwise, to the business involved in the principal transaction.

With the exception of *Local Finance,* which generated four opinions in the Tax Court and which the court below considered and rejected, the courts have uniformly refused to accord the Commissioner the power to rearrange the transactions to exact the maximum tax by attributing income to one who could not lawfully receive it.

III.

Under the guise of reallocating gross income the Commissioner is really passing hindsight judgment on the rate structure of the credit insurance industry and the profit of Security Life, insisting that a life insurance company must always pay a certain amount of commissions and that the minimum effort required for the Banks to offer their loan customers a mutually beneficial service earned those commissions. This argument completely disregards the Record, which shows that the premium charged by the unrelated insurance company was the "going rate," there is no fixed commission element in insurance premiums, and Security Life took a great risk for the premiums it received, for which it was entitled to be compensated.

IV.

Notwithstanding the broad scope of Section 482, there is no power on the part of the Commissioner to create income in the hands of a taxpayer who did not—and could not—receive it because of legal prohibitions. A rule attributing illegal income and taxing such attributed illegal income would create an unthinkable dilemma between federal taxing and banking laws and produce the unconscionable result of exacting a tax where there could be no income and, hence, where no part of the money being taxed is available to discharge the tax liability.

ARGUMENT

I. SECTION 482 CANNOT BE USED TO TAX THE BANKS ON INCOME WHICH THEY DID NOT—AND COULD NOT LAWFULLY—RECEIVE.

A. The Commissioner Misconstrues His Own Regulations: § 482 Applies Only Where the Exercise of Common Control Has Resulted in Understating the True Taxable Income of One Entity in Favor of Another.

Section 482 authorizes the Commissioner to allocate income and deductions among commonly controlled business entities if he determines that such allocation is necessary in order to prevent "evasion of taxes or clearly to reflect the income" of any such entities. This provision, which first appeared in its present form in the Revenue Act of 1928, was designed—

> "* * * to prevent evasion (by the shifting of profits, the making of ficticious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability." H. Rep. No. 2, 70th Cong., p. 16 (1939-1 Pt. 2 Cum. Bull. 395).

The Commissioner mistakenly assumes (Br. 15-16) that there is no dispute between the parties over his statement that the test under §482 is whether the "arrangements" would not have been the same or whether the related parties "have not acted as they would have in identical, but uncontrolled, arm's length dealings." This statement is far broader than the statute—or the Commissioner's own regulations implementing the statute—warrants.[5] According to the regulations (set forth in Pet. Br. App. 37-38), the scope and purpose of §482 is—

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5. For a comprehensive current discussion of judicial developments with respect to § 482 see, Aland, *"Section 482—1971 Version"* 49 TAXES 815 (Dec. 1971).

> "* * * to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer." Regs. §1.482-1 (b)(1).

The premise underlying the statute is that—

> "The interests controlling a group of controlled taxpayers are *assumed* to have *complete power* to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers." Regs. § 1.482-1(b)(1). (Emphasis supplied.)

The key to §482, therefore, is the existence of power to cause "the arbitrary shifting of profits among related business entities." See S. Rep. No. 275, 67th Cong., Ist Sess. (1921), 1939-1 Cum. Bull. (Pt. 2) 181, 195 discussing § 240 of the Revenue Act of 1921—the predecessor of § 482. It is only where the power exists—and has been exercised in such a way that the taxable income of a controlled entity has been "understated"—that the Commissioner is authorized to reallocate. Regs. §1.482-1(b)(1). Stated differently, the Commissioner may not allocate income in ways that the controlling interests did not themselves have the power to accomplish.

The *test* for determining whether an allocation is authorized under Section 482 because the power exists and has been exercised to shift (and therefore understate) income is whether—

> "* * * the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an un-

controlled taxpayer, dealing at arm's length with another uncontrolled taxpayer." Regs. §1.482-1(c).

The Tenth Circuit explicitly adopted that test (R.187) and the Commissioner does not directly repudiate the test here. He does, however, attempt to change the focus of the statute by urging that the test is whether the "arrangement" would have been different absent the controlled relationship. (Br. 15, 16.) Section 482, its legislative history, and the Regulations clearly indicate that the only pertinent inquiry is whether the Banks' income was "understated" by reason of the common control of the Banks and Security Life and whether the Banks' income would have been any different in an uncontrolled situation. These are the questions which must be answered.

B. The Commissioner Has Misapplied His Own Regulations: The Holding Company's Control Over the Banks and Security Life Did Not Result In Understating the Banks' Income.

National banks in towns over 5,000 population are prohibited from receiving insurance commissions. Rev. Stats. §5202 (12 U.S.C. (1946 ed.) 92; Pet. Br. App. 39).[6] Penalties for violating that federal law are severe: Forfeiture of the bank's charter and personal liability on the part of the Directors. Rev. Stats. § 5239 (12 U.S.C. 93; Pet. Br. App. 40).

The Commissioner now acknowledges that it was the Banks' understanding of this statute that "prompted them

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6. While the Commissioner raises some question whether § 5202 remains in force, he acknowledges that the Comptroller of the Currency's current regulations incorporate that proscription and that the Courts have invalidated a 1963 ruling of a prior Comptroller to the contrary. (Pet. Br. 28, n. 14.)

to structure their affairs so as to remain aloof from the receipt of insurance-related income". (Br. 29.)

Due to the federal banking law, the fundamental prerequisite of §482 is absent in this case: The Holding Company did not have "complete power" to cause the Banks to take commissions, and thus lacked the power arbitrarily to shift any such income away from the Banks.

In the leading case dealing with the application of § 482 to a situation where the controlled entity was prohibited by law from receiving the income sought to be allocated, the Tax Court squarely held that the Commissioner could not allocate income which could not lawfully be received.

In *L.E. Shunk Latex Products, Inc.* v. *Commissioner,* 18 T.C. 940, a classic § 482 situation,[7] the same interests controlled a manufacturer and a distributor of rubber prophylactics. During the sharply rising market following Pearl Harbor, the distributor raised its prices to retailers, but the manufacturer failed to raise its prices to its related distributor. Shortly thereafter, an OPA regulation froze the manufacturer's price as of December 1, 1941, so that it could not have *lawfully* charged more—either to its own or an unrelated distributor. The Court held that the OPA regulation had the effect of—

> "* * * prohibiting petitioners from *receiving* the very income sought to be attributed to them. We think that the Commissioner had no authority to attribute to peti-

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7. In contrast to *Shunk* and many other § 482 cases, this case does not involve a closely held corporation situation where director-officer-owners stand to enrich themselves through corporate devices. The Banks are publicly owned through the Holding Company, with independent businessmen from many segments of industry as directors. (R. 17, 21.)

> tioners income which they *could not have received.*" (18 T.C. at 961.) (Emphasis supplied.)[8]

Moreover, the Commissioner himself has recognized, in other contexts, that legal prohibitions against the receipt of income will preclude the application of § 482. On October 8, 1971, the Commissioner issued Technical Information Release No. 1106, with respect to the current wage-price freeze, stating that taxpayers who accumulate earnings in excess of the reasonable needs of their business will not be subject to the accumulated earnings penalty tax of § 531 of the Code, to the extent that the excess accumulation could not be distributed as a dividend without violating the Cost of Living Council's Guidelines. And in § 482-1(d)(6) of the Regulations, the Commissioner states that no tax will be imposed on a domestic parent as a result of a § 482 allocation if the parent is unable to receive the allocated income

8. The Commissioner (Br. 33) attempts to distinguish *Shunk* on the ground that the taxpayer could not raise its price since it was fixed by law ("*de jure*"). But the taxpayer certainly could have raised its price—it would simply have violated the law by so doing. The same is true here: The Banks could have taken commissions if they had been willing to violate the law. The Court's statement in *Shunk* that the Commissioner *may not "attribute to petitioners income which they could not have received"* (emphasis supplied), does not mean that the taxpayer could not physically have received the money in violation of the law, since it obviously could. It means that when taxpayers in good faith structure their affairs in compliance with a law which vitiates the controlling taxpayer's power to shift income, the Commissioner may not (1) force them into an unlawful act by virtue of an artificial allocation, or (2) by such an allocation, exact a tax where there can never be any income.

due to legal prohibitions of the foreign country of the subsidiary.[9]

Thus, where the interests controlling a related group do not have the legal power to cause the taxpayer in question to receive the income sought to be allocated, it is the legal prohibition—and *not the control element*—which is responsible for any conceivable economic understatement of income; hence, there is nothing on which § 482 can operate. So here, because of the legal prohibition in the federal banking laws, the Banks' income would not have been greater regardless of the control element.

Both courts below found that the banks "* * * never received or attempted to receive commissions or reinsurance premiums resulting from their customers' purchase of credit insurance."[10] (R.172, 188.) Conversely, as pointed out by the Court of Appeals—

> "* * * the Tax Court made no finding that if Security Life did *not* exist the Banks would then receive or attempt to receive any such income." (R.188.) (Emphasis supplied.)

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9. In this case, the Commissioner's allocation would result in imposing a tax on the Banks, although they could never obtain the income which gave rise to the tax from Security Life, which, in 1959, became a subsidiary of an unrelated corporation. That separation renders ineffective the correlative adjustment reducing Security Life's income, suggested by the Commissioner. (Br. 8, n. 3.)

10. The Commissioner's comment that lack of "receipt" of money is irrelevant to the application of § 482 (Br. 22), completely misses the point made by the Tenth Circuit that due to prohibitions of federal banking law, the Banks had *no power* to receive the income. Conversely, since the banks had never taken insurance-related income illegally, the Commissioner's citation of cases taxing income actually, though illegally, received is irrelevant. (Pet. Br. 29-30.)

The Court of Appeals concluded that—

> "In an uncontrolled situation with arm's length dealing, the Banks, on the basis of the findings made, would not have taxable income from the credit insurance transactions." (R.188.)

These findings by the Courts below are buttressed by the fact that for six years *prior* to the formation of Security Life, the Banks (due to federal law) did not receive any income from the purchase of credit life insurance by their loan customers. (R.188.)

The fatal underlying weakness of the Commissioner's brief is his refusal to accept those facts. His entire argument is premised upon the false and unsupported assumption that the Banks would unlawfully take insurance commissions in an uncontrolled situation (e.g., Br. 19-20, 23-24, 25, 31, 34). Such a premise erroneously assumes that the directors of the Banks would break the law.

The Commissioner, lacking any factual support for his position, resorts to a novel legal definition of the word "income" as used in § 482.

C. The Banks Realized No Income As that Term is Used in the Tax Laws.

For the first time in this litigation, and, to our knowledge, in any court anywhere (including *Local Finance*), the Commissioner is urging a definition of "income" under § 482 larger in concept and scope than the same word when used anywhere else in the Internal Revenue Code and Regulations. (Br. 23.) Only through this approach can he sustain his argument that, although the Banks did not—and cannot ever—receive any income, they must have received some theoretical income which the Commissioner may now allocate and upon which he proposes to charge a very real tax to the Banks.

There is no indication in the legislative history of § 482 that Congress intended to redefine gross income, as used in that Section. Section 482 only authorizes the Commissioner to allocate "gross income"—a term that is defined in § 61. Moreover, the thrust of § 482 is merely to determine the same taxable income for a controlled taxpayer as he would have had if uncontrolled. Regs. § 1.482-1 (a)(6), (b)(1), and (c). All roads, therefore, lead back to the concept of income as it has evolved through the interpretation of § 61.[11]

It is not hard to see why the Commissioner now wishes to redefine income altogether and avoid the § 61 guidelines and concepts of income developed by this and other courts over the years, which are wholly incompatible with the result the Commissioner is urging here.

As this Court said in *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 431, income has been held to encompass all—

> "* * * accessions to wealth, *clearly realized*, and over which the taxpayers have *complete* dominion." (Emphasis supplied.)

This concept fits together with the elements of "volition" or voluntary conduct, and the existence in the taxpayer of alternatives, as developed in such cases as *Helvering* v. *Horst*, 311 U.S. 112, *Corliss* v. *Bowers*, 281 U.S. 376, and

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11. To hold that § 482 is but a specific application of the income principles of § 61 in a controlled entity situation would not make § 482 superfluous, as the Commissioner suggests. (Br. 23.) It is well established that the Commissioner's determination under § 482 is entitled to such great weight that it cannot be overturned unless arbitrary and capricious—a much greater burden than in the ordinary deficiency case, where the Commissioner's determination is merely prima facie evidence. See *Grenada Industries, Inc.* v. *Commissioner*, 17 T.C. 231, affirmed 202 F.2d 873 (5th Cir.), certiorari denied, 346 U.S. 819. Other reasons are stated by the Second Circuit in *Rubin* v. *Commissioner*, 429 F.2d 650, 653-654.

Harrison v. *Schaffner,* 312 U.S. 579. The concept is expressed in *Corliss* v. *Bowers, supra,* at 378, where Mr. Justice Holmes remarked for the Court:

> "* * * income that is subject to a man's *unfettered* command and that he is *free to enjoy* at his *own option* may be taxed to him as his income, whether he sees fit to enjoy it or not." (Emphasis supplied.)

No decision of this Court deviates from the concept that before there is income the taxpayer must have the alternative, *at his option,* of either taking the income for himself or diverting it to someone else. Voluntary conduct based on the existence of alternatives is the very heart of that concept. Conversely, this Court has *never* held that a person may be taxed on income which he could not ever have received.

In this case, the Banks had no option. There was no question of voluntary conduct with respect to alternatives in electing to receive or not receive the income in question. This is the answer to the Commissioner's argument (Br. 19) that the Banks must be taxed because their minimal services were the *sine qua non* of the credit insurance business.

Taxation has never been predicated solely upon whether a person performs activities constituting the *sine qua non* of income (such as employees, trustees, parents' investment decisions for children, etc.). The touchstone has been the existence in the taxpayer of an "unfettered command" over the income—the right to enjoy it at his own option. *Corliss* v. *Bowers, supra; Commissioner* v. *Glenshaw Glass, supra.*

The result of the Commissioner's novel theory would be to substitute the subjective judgment of the tax administrator (as to whose effort produced what, and the quantum and "value" of effort measured against resulting income,

etc.) for clearly recognized standards—creating a tax concept virtually impossible to administer. It would also create a climate of uncertainty for taxpayers and their advisors.

One of the reasons why the *sine qua non* of business, alone, will not subject the generating party to a tax on all succeeding profit is that the generating party often will initiate the transaction in question for reasons unrelated to such profit. For example, in this case, making credit insurance available to borrowers contained its own built-in rewards to the Banks quite apart from the profit which preoccupies the Commissioner. George Eccles, President of the Banks, testified that credit life, health and accident insurance on borrowers was beneficial to the Banks as security for their loans. (R. 57.) No truer statement was ever made. During the years in suit such insurance paid off more than $500,000 in bank loans on death claims alone, against a negligible processing cost of only $2,000 per year per Bank. (R. 184.)

On similar facts, the Court of Appeals for the Seventh Circuit stated:

> "This Court should be slow to override the business judgment of petitioners that lending their facilities to the credit insurance business was beneficial." *Nichols Loan Corp.* v. *Commissioner,* 321 F.2d 905, 907.

The fact that *de minimis* amounts of time and expense were involved in the insurance paperwork in question, plus the fact that insurance was merely a minor incident to the Banks' major business of making loans, is also significant. In making the point that insurance was simply an incident to the main purpose of the business, the court in *Ray Waits Motors, Inc.* v. *United States,* 145 F. Supp. 269, 271, 272 (E.D. S. Car.), refused to allocate insurance income

to a car dealership, saying that the actions of the salesmen in asking customers about insurance were—

> "* * * *merely perfunctory duties connected with the main object*, which was the sale of the motor vehicle.
>
> * * *
>
> "The place of business of the plaintiff corporation was operated *primarily for the sale and repair of motor vehicles and not for the sale of insurance.*" (Emphasis supplied.)

Even in circumstances where very substantial services were rendered, the Courts have rejected the Commissioner's *sine qua non* theory of income. In *Teschner* v. *Commissioner,* 38 T.C. 1003 (1962), the Tax Court refused to tax a father who, disqualified by contest rules from receiving a prize, submitted a winning entry in his daughter's name. The Court stated (38 T.C. at 1007, 1009):

> "Such results, completely at variance with every accepted concept of Federal income taxation, demonstrate the fallacy of the premise.
>
> * * *
>
> "Where an individual neither receives nor has the right to receive income, he is not the taxable individual within the contemplation of the statute. There is no basis in the statute or in the decided cases for a construction at variance with this fundamental rule."

See also *Basye* v. *United States* (9th Cir.), decided September 16, 1971, unofficially reported at 71-2 U.S.T.C. ¶ 9648, p. 87,552, affirming 295 F. Supp. 1289 (N.D. Calif.); and, Sieroe and Gerber, *"Section 482—Still Growing At the Age of 50"*, 46 Taxes 895, 900-902 (Dec. 1968), referring to the Commissioner's theory in this case as "... having truly frightening implications".

II. LOCAL FINANCE CONFLICTS WITH ALL APPLICABLE PRECEDENTS

Over the years, corporations such as banks, finance companies, and automobile dealers, precluded by state law from receiving compensation from the sale of insurance to their customers, have devised different methods of handling their affairs so as to allow related parties to profit where they themselves could not. Using as his pivotal argument the fact that employees of these businesses sold the insurance and handled the necessary paper work, the Commissioner has tried every weapon in his arsenal to restructure these transactions. Until the decision in *Local Finance Corp.* v. *Commissioner,* 48 T.C. 773, affirmed, 407 F.2d 629 (7th Cir.), certiorari denied, 396 U.S. 956, the lower courts have rebuffed the Commissioner at every turn, recognizing the problem posed by state law and the right of taxpayers to structure their business affairs as they choose,[12] regardless of tax savings.[13]

The most common arrangement was for the individual owners of the corporation to take out an insurance agency license and receive insurance commissions personally. The courts readily accepted such arrangements where the presidents and principal shareholders of family automobile businesses acted as casualty insurance agents—even though the actual work may have been done by the employees of the corporation without additional compensation. *Ray Waits Motors, Inc.* v. *United States,* 145 F. Supp. 269 (E.D. S. Car.); *Moke Epstein, Inc.* v. *Commissioner,* 29 T.C. 1005; *Gaddy Motor Company, Inc.* v. *Commissioner,* T.C. Memo. 1958-189 (17 T.C.M. 944); *Jaeger Motor Car Co.* v. *Commissioner, T.C. Memo.* 1958-223 (17 T.C.M. 1098), affirmed, 284 F.2d 127 (7th Cir.), certiorari denied, 365 U.S. 860.

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12. *Moline Properties, Inc.* v. *Commissioner,* 319 U.S. 436; *National Carbide Corp* v. *Commissioner,* 336 U.S. 422.

13. *Gregory* v. *Helvering,* 293 U.S. 465.

Similarly, in the field of credit life insurance such individual or partnership insurance agencies have been upheld and no attribution of commission income to the related financial institutions has been permitted, despite various arguments that, under Section 61 of the Code, the insurance agencies should be disregarded as a "sham," that the income was really earned by the corporation whose employees sold and serviced the insurance, and that Section 482 authorized a reallocation of income. *Campbell County State Bank, Inc.* v. *Commissioner*, 37 T.C. 430, reversed, on other grounds, 311 F.2d 374 (8th Cir.); *Paramount Finance Co.* v. *United States*, 304 F.2d 460 (Ct. Cl.); *Bank of Kimball* v. *United States*, 200 F. Supp. 638 (S.D.); *Nichols Loan Corp.* v. *Commissioner*, T.C. Memo. 1962-149 (21 T.C.M. 805), reversed on other grounds, 321 F.2d 905 (7th Cir.); *First Security Bank* v. *United States*, 213 F. Supp. 862 (Mont.), affirmed, 334 F.2d 120 (9th Cir.); *First State Bank* v. *United States*, (D.C. S.D., decided June 25, 1962; unofficially reported at 62-2 U.S.T.C. ¶ 9613).

Another type of transaction, developed subsequently, was to eliminate the insurance agency "middle man" and form a separate insurance company to arrange with the unrelated insurance carrier for reinsurance of the mortality risk. Although this meant giving up guaranteed commissions, there was a possibility of a greater profit through the assumption of an underwriting risk. In *Alinco Life Insurance Company* v. *United States*, 373 F.2d 336 (Ct. Cl.), the Commissioner attacked this arrangement, contending that, under Section 269, the reinsurance company was not entitled to be taxed as a life insurance company under Section 801 *et seq.* of the Code because it had been formed primarily to avoid taxes by securing the benefit of life insurance status. The Court of Claims, however, held that it was not tax avoidance to structure business affairs in response to the requirements of state law and that there could be no objection to arranging one's

affairs to take advantage of the treatment afforded to life insurers by the Code.

In *Local Finance,* which generated four separate opinions in the Tax Court, all of these precedents were swept aside. Judge Fay, dissenting, stated (48 T.C. at 803):

> "It is particularly noteworthy in this context to consider the past history of respondent's attempts to attack various business-connected insurance arrangements. Respondent has pitched his arguments on sections 61, 269, 482, and a general argument that income was properly taxable to a lending institution rather than a controlled reinsurer or the shareholders of the lending institution as partners of an insurance agency. All these approaches have been repeatedly rejected by this and other Courts."

Unable to distinguish the facts in *Local Finance* from the Tax Court's earlier decisions, Judge Fay remarked on the court's inconsistency (48 T.C. at 802):

> "* * * I am left with the curious result that where employees of lending institutions perform services regarding credit life insurance the stockholders of those institutions may validly take a profit from the insurance business by setting up a partnership to receive it but may not validly take, in effect, the same profit by setting up a legitimate insurance company to reinsure the risk."

Throughout this entire litigation the Commissioner has refused to face up to the fact that not one of the cases just cited could have been decided as they were under an application of the Commissioner's theory urged upon this Court. The Court of Appeals recognized that fact, pointing out that this case is indistinguishable in principle from those cases. (R. 190.)

The Tenth Circuit's opinion in this case is in accord with the applicable precedents, making *Local Finance* the sole aberration in a long line of cases refusing to tax institutions, whose business contact with customers provided an incidental opportunity to offer insurance, on income which they did not receive.

III. THE COMMISSIONER, UNDER THE GUISE OF ALLOCATING INCOME, DOES NOT HAVE THE POWER TO RESTRUCTURE BONA FIDE BUSINESS TRANSACTIONS.

A recurring theme of the Commissioner's brief is that 40% of the credit insurance premiums received by Security Life belonged to the Banks as commissions and did not constitute true income to which Security Life was entitled as compensation for reinsuring risks. Implicit in this argument are several unsupported and erroneous propositions: that the premium rate was excessive, that life insurance companies must always pay commissions, that commissions are a fixed element of the premium rate, that Security Life made excessive profits, and that taxes were improperly avoided. The Commissioner then arrogates to himself the right to determine, on hindsight, how much of Security Life's credit insurance premium income represented excess profit to be classified and disgorged as commission income to the Banks, purportedly to compensate them for offering insurance to their customers incidental to loan transactions.

Factually, however, the record shows: that the premium charged to the Banks' customers was the prevailing rate approved by the insurance commissioners[14] (R.68, 104, 170),

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14. The Commissioner's reference (Br. 20) to the legislative history of the Life Insurance Company Tax Act of 1955 is misplaced. The committee reports stated the belief that § 482 would come into play where a finance company had a credit life insurance subsidiary only when "the subsidiary charges excessive premium"—"higher than the going rate"—and the finance company's interest rate was correlatively reduced. S. Rep. No. 1571, 84th Cong., 2d Sess., 1956-1 Cum. Bull. 967, 971-972); Committee on Ways and Means, Taxation of Life Insurance Companies, Report By The Subcommittee on Taxation of Life Insurance Companies (1955, 83d Cong., 2d Sess. (Subcommittee Print)), p. 46. This refers to what would be a classic § 482 situation, namely, where the insurance premium was excessive and the interest rate was correlatively reduced. Here, the premium was not excessive (it was the "going" rate) and there was no "milking" of the Banks' interest income.

that there is no fixed amount of any premium which is set aside for the payment of commissions (R.84-85), that it was only "fairly common" (certainly not universal) for lending institutions to ask for compensation for offering insurance to their customers (R.105), and that the cost to the Banks of handling credit insurance, incidental to the principal loan transactions, was minimal and was a service required by competition and worthwhile to the Banks (R.166, 169): see also *Nichols Loan Corp.* v. *Commissioner, supra,* where because of the minimal cost and commensurate benefits to the finance companies, the court refused to disallow a deduction to the finance companies for the cost of selling and servicing credit insurance, even though commissions were paid to a related insurance agency.

One of the reasons why the Commissioner has fallen into these factual errors is that he fails to separate the function of insuring risks from the business of selling insurance. The business structure involving a guaranteed commission payable to Smith, on which the Commissioner relies so heavily, was quite different from the underwriting venture of Security Life—and Security Life was entitled to be compensated for its great risk. (R.83.) As the Court of Claims commented in *Alinco Life Insurance Co.* v. *United States,* (373 F.2d at 345):

> "* * * what [the finance companies] really did in this case was to give up guaranteed commissions in return for the possibility of a greater profit through the assumption of an underwriting risk."

And as Judge Drennan said, dissenting from the majority opinion in *Local Finance* in the Tax Court (48 T.C. at 799):

> "If the premiums chargeable and charged for this type insurance were more than adequate to cover the cost of writing it and the risk involved, I do not believe either the Commissioner or this Court should attempt to allocate the excess to the cost of performing the services of writing the insurance rather than to the risk involved, which [the reinsurance company] assumed."

The Commissioner completely ignores the magnitude and significance of the risk assumed by Security Life, which grew from $6,483 at the end of 1954 to $41,350,000 at the end of 1959. (R.171.) The evidence in this case, offered primarily through two expert witnesses who testified without challenge by the Commissioner on cross-examination, is that the size and nature of the risks assumed by Security Life required it to retain every dollar it received. (R.33, 85-86, 94, 100, 147-153, 171.) The Commissioner's submission to the contrary (Br. 5, 18) is based upon the testimony of Clarence Tookey, and averages derived by hindsight from the lump sum result of six years' operation.

On cross-examination, Mr. Tookey, after prodding by the trial judge, admitted that his experience in the credit insurance industry was limited to three companies: two in which he appeared as a witness for the Government, and one client. (R.113-115.) He also admitted (1) that he had not consulted publications or been in contact with representatives of the credit insurance industry (R.123); (2) that he used figures from outdated reports which had very little useful purpose (R.113, 115), although he had current reports in his possession (R.125. See R.91, 95-97); (3) that he had no idea what rates he would have considered safe in 1954 (R.116); and (4) that he had not studied the business of Security Life (R.109-110).

By averaging, the Commissioner avoids the rising trend of losses suffered by the Company (the Company's annual statements (Ex. B0-40) show losses of 37% in 1959 (compared to 20% in 1955), and lumps accident and health insurance lines with life insurance, thus avoiding the fact that by 1959 losses on accident and health insurance were in excess of 50% of premiums (Ex. B0-40).[15] Depriving his hindsight

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15. By 1964, American National's losses on *all* lines of credit insurance in the state of Utah were 50% of premiums.

six year "profit" figure of averaging and lumping, the Commissioner's allocation theory would result in a 1.4% profit to Security Life on credit life insurance in 1959, and a *loss* of 11.6 cents on each credit accident and health premium dollar (R.170-171, Ex. B0-40). Stated another way, the Commissioner's theory would allow Security Life a profit of $5,075 for reinsuring $6,483,000 of risk covering 12,500 policyholders in 1954 (less than one-tenth of one percent profit on risks assumed); a profit of $48,300 for carrying $13,360,000 in insurance risk on 27,594 policyholders in 1955; $43,703 profit on $21,105,000 of risk on 34,388 policyholders in 1966, and so on. (R.170-171, Ex. B0-40.) Such profits are *not* reasonable when, on a prospective rather than hindsight basis, just a few extra deaths out of thousands of shareholders would have entirely eliminated any profit at all each year. In fact, the Commissioner's theory that Security Life had excessive profits was so untenable that just prior to trial he decided to eliminate from his proposed allocation premiums on mortgage, borrow-by-check, and twin dollar credit insurance, all of which experienced high losses. (R.125, Exs. B0-40, BZ-51.)

On these facts, the question must be asked whether there is any legal basis for the Commissioner to use specious hindsight analysis to transform $800,000 of Security Life's premium income (subject to insurance risk and reserve requirements when received) into commission income and claim that it merely represents compensation for services which cost each Bank less than $2,000 annually to perform.

The Commissioner's sole reliance is on a novel interpretation of § 482, which, if adopted, would give him protean power to restructure bona fide arrangements made by an affiliated group to comply with regulatory laws, so as to

exact the maximum possible tax from the group as a whole.[16] But § 482 will not stretch that far: Its focus is not on the arrangements which related taxpayers may make, but on the *results* of those arrangements, to avoid the arbitrary understatement of the income of one controlled entity in favor of another. Here, since the Banks were prohibited by law from taking insurance income, there was no understatement of the Banks' income to bring § 482 into play and the Commissioner cites no other law which authorizes him retroactively to restructure the arrangement.[17]

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16. Certain statements in the Commissioner's brief suggest that he misunderstands the purpose and history of § 482 and would like to tax the Holding Company and its subsidiaries on a consolidated return basis: For example, he refers to the proliferation of entities used to conduct what is basically a "single economic enterprise" (Br. 13); and he scores the reinsurance arrangement under attack as resulting "in a smaller total tax liability for Holding Company and its subsidiaries." (Br. 7, 27.) But the Banks and the Insurance Company performed entirely different functions and are not a "single economic enterprise;" and, in any event, the Commissioner's own regulations emphasize that § 482 is not intended to "produce a result equivalent to a computation of consolidated taxable income * * *." Reg. § 1.482-1(b)(3)

17. Although the Commissioner makes a passing reference to the tax evasion phrase of §482, and tax savings accorded life insurance companies until 1959 (Br. 4, 7, 34), he nowhere undertakes to argue that his proposed allocation of income is supported by that element of the statute. And neither court below made any such finding. In his discussion of *Campbell County State Bank, Inc.* v. *Commissioner, supra,* the Commissioner concedes (as pointed out by the Tax Court in *Campbell,* 37 T.C., at 438-439), that compliance with the law is a business purpose, not a tax saving purpose (Br. 33) and in effect admits that tax avoidance motives were not control factors here (Br. 31, n. 15). More recently, the Court of Appeals for the Fourth Circuit found that compliance by a national bank with the federal banking law involved in this case constituted a business, not a tax motive. *Mary Archer Morris Trust, North Carolina National Bank Trustee* v. *Commissioner,* 367

Indeed, his attempt to do so, runs squarely counter to all of the applicable precedents (except *Local Finance*) and to the maxim, as well entrenched in tax law as any the Commissioner cites, that a taxpayer is free to structure his affairs in any form, to comply with applicable laws, regardless of whether it results in a tax saving. See the decisions of this Court cited in notes 12 and 13; *Stearns Magnetic Mfg. Co.* v. *Commissioner,* 208 F.2d 849, 852 (7th Cir.); and *Seminole Flavor Co.* v. *Commissioner,* 4 T.C. 1215, 1235. The Commissioner should not be allowed to use a distorted view of his powers under § 482 to restructure business transactions in accordance with his hindsight view of what the profit and loss of each entity should have been and what tax they should have paid, on a consolidated basis.

F.2d 794, 795, 799. Of course, as shown by the tax returns of the entities involved, for the six years prior to the formation of Security Life, commissions paid to Smith were taxed in the highest corporate bracket (R. 20). Obviously during that time, the Banks' motive in remaining entirely aloof from insurance commissions was not tax avoidance but, as found by the courts below and now admitted by the Commissioner, to comply with federal law (R. 172, 187, Br. 29).

IV. THE COMMISSIONER'S POSITION TRAPS THE BANKS BETWEEN CONFLICTING FEDERAL LAWS AND CREATES AN UNREASONABLE DILEMMA.

The Commissioner wants this Court to allow him to allocate, on paper, a theoretical $800,000 from Security Life to the Banks, notwithstanding the fact that the Banks cannot receive that income due to prohibitions of the federal banking laws. The result will be to tax the Banks $400,000 for years in suit (and probably in excess of a million dollars for the years 1959 to the present) on nonexistent income—a truly absurd and incredible application of the tax laws. Moreover, such a result would have a detrimental effect on the financial condition of these national banks.

The Commissioner argues that the fault of the unthinkable predicament created by his theory in this case is not really his since *he*, "never forced" the Banks to have credit insurance available on their premises and, at any rate, all the Banks had to do was lower the premium rate so that it did not include money for commissions. (Br. 31-32.) That argument lacks support from the Record, warps the facts of this case and commercial reality beyond recognition, and asks this Court to make the Commissioner a regulatory agency over the banking and insurance industries. The Banks do not set the premium rates. They have no control over them whatsoever. (R. 68-69.) And even if the Banks could dictate rates to independent insurance companies, such as American National, the uncontradicted evidence is that there is no such thing as a fixed commission element in any premium rate. (R. 37.) A rate could be fixed so low that the insurance company operated at a loss and the company could still choose to pay commissions. Thus, the only way "commissions" could be "eliminated" from premium rates would be for the Commissioner to determine and promulgate his notion of what such an amount would be each year for each company.

The Commissioner's theory thus traps the Banks in a conflict between federal laws, leaving the Banks with the unreasonable alternatives of (1) paying taxes on income which they never have and never can receive; (2) breaking the law and attempting to receive such income from 1972 on, resulting in the loss of their bank franchise and personal liability imposed on their directors; (3) discontinuing insurance for their customers entirely, thus stripping the Banks of loan protection and other customer benefits; or (4) foregoing the opportunity of enabling a related entity, not forbidden by law, from realizing an economic benefit which the Banks could not take.

The unconscionable result of the Commissioner's tax on nonexistent income in this case—the impossible dilemma in which it places the Banks—falls within the language of this Court in *Farmer's Loan & Trust Co.* v. *Minnesota,* 280 U.S. 204, 212:

> "Taxation is an intensely practical matter and laws in respect of it should be construed and applied with a view of avoiding, so far as possible, unjust and oppressive consequences."

CONCLUSION

Our tax laws do not countenance a theory—such as that now urged upon this Court by the Commissioner—which would result in exacting a tax where there *never* could be any income to the taxpayer.

The decision of the Court of Appeals should be affirmed.

Respectfully submitted,

S. J. QUINNEY
ALONZO W. WATSON, JR.
STEPHEN H. ANDERSON
RAY, QUINNEY & NEBEKER
400 Deseret Building
Salt Lake City, Utah 84111

Counsel for Respondents

CERTIFICATE OF SERVICE

I, STEPHEN H. ANDERSON, hereby certify that three copies of the foregoing Brief for the Respondents, First Security Bank of Utah, N.A., et al, were air mailed by me by depositing the same in a United States Post Office, postage prepaid, pursuant to paragraphs 2 and 3, Rule 33 of the Rules of the Supreme Court of the United States, to ERWIN N. GRISWOLD, Solicitor General, Department of Justice, Washington, D.C. 20530, this 29th day of December, 1971, and that all parties required to be served have been served.

STEPHEN H. ANDERSON
Counsel for Respondents